No. 138

In the Supreme Court of the United States

OCTOBER TERM, 1952

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HALL C. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE COMMISSIONER

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OPINIONS BELOW

The opinion of the Tax Court (R. 21-25) is reported at 11 T. C. 174. The affirming order of the Court of Appeals (R. 30) is reported at 194 F. 2d 536.

JURISDICTION

The judgment of the Court of Appeals was entered on February 12, 1952 (R. 30). A petition for rehearing, filed on March 1, 1952, was denied on April 11, 1952 (R. 31-33). The petition for a writ of certiorari was filed June 18, 1952, and granted on October 13, 1952 (R. 34). The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

QUESTION PRESENTED

In 1943 taxpayer received salary from a corporation owned by him and reported it in full in his income tax return for that year. In 1951, however, as a result of litigation, it was finally determined that the compensation was excessive and that, to the extent of the amount determined to be excessive, taxpayer was liable as a transferee for tax claims against the insolvent corporation. May taxpayer's 1943 tax be recomputed so as to exclude from his income for that year the amount of compensation subsequently held to be excessive and subject to transferee liability?

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 42.)

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same

manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter * * *:

(1) *Transferees.*—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

* * * * *

(26 U. S. C. 1946 ed., Sec. 311.)

STATEMENT

The facts as stipulated (R. 19–21) were adopted by the Tax Court as its findings (R. 22). They may be summarized as follows:

During the fiscal years ending July 31, 1942, and July 31, 1943, taxpayer was the president and sole stockholder of the Charles E. Smith & Sons Company. For these two fiscal years the company paid to taxpayer for his services a salary of $52,000 and $87,265.08, respectively, and deducted these amounts in its income and declared value excess profits tax returns for those years (R. 19–20, 22).

Taxpayer reported these amounts in full in his income tax returns for the calendar years 1942 and 1943, and paid the tax shown to be due thereon. It is expressly stipulated that he received these amounts (R. 20)—

> under a claim of right and has ever since retained said amount of salaries, and had no knowledge of the proposed disallowance

of said salaries as a deduction to said company until September of 1944.

Subsequent to the filing of the 1942 and 1943 returns, the Commissioner determined tax deficiencies against the company for 1942 and 1943, based in part upon the disallowance as deductions of $27,000 of the salary paid to taxpayer in 1942 and of $57,265.08 of the salary paid to him in 1943, the Commissioner having determined that to the extent of those amounts the salary paid to taxpayer exceeded a reasonable allowance for compensation for his services to the company.[1] The Commissioner also determined that to the extent of the excessive salary, $27,000 for 1942 and $57,265.08 for 1943, taxpayer was liable as transferee for the company's tax deficiencies. The company and taxpayer each contested the Commissioner's determinations and filed petitions with the Tax Court, which were consolidated for hearing. In the proceeding brought by the company, the Tax Court sustained the Commissioner's action in disallowing the above-stated portions of taxpayer's 1942 and 1943 salary as deductions. In the proceeding brought by taxpayer, the Tax Court held that taxpayer was liable as transferee for the unpaid taxes of the company to the extent of the excessive compensation he received

[1] The record in *Charles E. Smith & Sons Co. v. Commissioner*, No. 545, 1950 Term (R. 9, 21) shows that "90-day" letters, advising the company and Smith that the Commissioner had determined deficiencies in tax liability, were dated September 13, 1945.

in 1943 ($57,265.08), since the payment of that amount to taxpayer rendered the company insolvent in 1943. (R. 20, 22; *Charles E. Smith & Sons Co.* v. *Commissioner,* decided May 12, 1947, 1947 P-H T. C. Memorandum Decisions, par. 47,128.)[2] Both the company and taxpayer appealed, and the Tax Court's decisions were affirmed by the Court of Appeals for the Sixth Circuit on October 20, 1950. *Charles E. Smith & Sons Co.* v. *Commissioner,* 184 F. 2d 1011. Certiorari was denied on March 26, 1951. 340 U. S. 953.

In the meantime, in January 1947, taxpayer filed a claim for refund of part of the tax paid on his 1943 return, on the ground that he was not taxable on such portion of the compensation he had received and reported in that year as might finally be determined to be excessive and subject to transferee liability. The claim for refund was denied by the Commissioner (R. 21). The Commissioner subsequently determined a deficiency against taxpayer for 1943 income tax based upon the disallowance of a deduction for payment of certain real estate taxes (R. 21). Taxpayer thereafter filed a petition for review with the Tax Court in which he alleged that, instead of a deficiency being due, he had overpaid his taxes and was entitled to a refund of the taxes he had paid on his excessive salary for 1942 and 1943 (R. 21).

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[2] The pertinent portions of the Tax Court's opinion are set out in the Appendix, *infra*, pp. 31–38.

The Tax Court held that taxpayer's 1943 tax liability should be recomputed by excluding from his 1943 reported income the excessive portion of his 1943 salary ($57,265.08) which under the Tax Court's decision in *Charles E. Smith & Sons Co.* v. *Commissioner*, *supra*, represented the extent of taxpayer's liability as a transferee for the unpaid 1942 and 1943 deficiency taxes and penalties of the company[3] (R. 21–25). The Court of Appeals affirmed (R. 30) and denied the Commissioner's petition for rehearing (R. 33).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In failing to hold that taxpayer received his 1943 salary, including the portion subsequently determined to be in excess of reasonable compensation, under a claim of right and without restriction as to its use and that, accordingly, the entire amount of the salary was taxable in 1943.

2. In concluding that taxpayer's receipt of the portion of his 1943 salary subsequently held to have been in excess of reasonable compensation constituted "the bare receipt of property or

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[3] The Tax Court's opinion was promulgated August 16, 1948 (R. 21), and its decision was entered October 26, 1948 (R. 25), both of which antedated the final determination in 1951 (*Charles E. Smith & Sons Co.* v. *Commissioner*, 184 F. 2d 1011 (C. A. 6th), certiorari denied, 340 U. S. 953) of whether and to what extent taxpayer was liable as transferee. However, the final determination was affirmance of the Tax Court's decision.

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money wholly belonging to another" and in holding, on the basis of that conclusion, that taxpayer's 1943 income tax liability should be recomputed by excluding the excessive compensation from his 1943 gross income.

SUMMARY OF ARGUMENT

The "claim of right" doctrine, applied by this Court in *North American Oil* v. *Burnet,* 286 U. S. 417, and *United States* v. *Lewis,* 340 U. S. 590, and recently reiterated in *Arrowsmith* v. *Commissioner,* decided November 10, 1952 (No. 51, October Term 1952), requires that income tax be paid in the year of receipt on money received under a claim of right and without restriction as to its disposition, even though it may in a later year be determined that the taxpayer was not entitled to retain the money and that he is legally required to return it or pay it over to someone else. In the present case it is stipulated that taxpayer received his entire 1943 salary under such a claim of right. He thus properly reported the entire salary as income in that year. Determinations made subsequent to 1943—that his 1943 salary exceeded reasonable compensation to the extent of $57,265.08, that payment of the excess rendered his corporate employer insolvent, that the corporation was liable for additional taxes to the Government, and that taxpayer is accordingly liable as transferee for the unpaid deficiency taxes of the corporation to the extent of the $57,265.08

constituting the excessive portion of his 1943 salary—establish his right to take a deduction in the year in which he satisfies such transferee liability, but do not entitle him to amend his 1943 return in order to reduce his taxable income for that year.

The decision below, holding that taxpayer's 1943 income tax may be recomputed by excluding the $57,265.08 from his 1943 gross income, is a fundamental departure from the "claim of right" doctrine. Presumably because taxpayer's transferee liability is based on the equitable theory that, as of the time of receipt, the excessive compensation constituted a constructive "trust fund" for payment of the transferor's deficiency taxes, the court below concluded that taxpayer's receipt of the excessive compensation constituted the receipt of money wholly belonging to another. But this "trust fund" existed only as a legal fiction, and it came into being only when it was determined, in a year later than 1943, that taxpayer was not legally entitled to retain such salary. That the chancellor could, for purposes of equitable relief, regard such a fund as if it had always been held in "trust," from the very moment it was received by the taxpayer, does not alter the realities of the transaction upon which tax liability and accounting must depend. Taxpayer did not receive the salary subject to an actual or express trust; as a practical matter, there was no restriction upon his disposi-

tion or use of it (cf. *Rutkin* v. *United States*, 343 U. S. 130, 137). It is expressly stipulated that at no time before 1944 did taxpayer have any knowledge that the company's deduction for such salary might be disallowed. The decision below is therefore based upon facts, determined subsequent to 1943, which defeated the taxpayer's claim of right to the excessive compensation at the time of receipt. But it is the existence of a claim of a right, and not a subsequent determination as to its ultimate validity, which is decisive.

Reversal of the decision below is required by the *North American Oil* and *Lewis* decisions of this Court, as well as by the rationale of *Rutkin* v. *United States*, *supra*.

ARGUMENT

The entire salary received by taxpayer in 1943 is taxable in that year, even though he was subsequently held liable as a transferee, under a theory of constructive trust, for the company's tax deficiencies to the extent of a portion of his salary

On appeal to the court below, the Commissioner argued that the entire salary received by taxpayer in 1943 is taxable to him in that year under the "claim of right" doctrine, which the Court of Appeals for the Second Circuit found no difficulty in applying to similar facts in *Commissioner* v. *Hartfield*, 194 F. 2d 662, now pending before this Court *sub nom. Healy and Hartfield* v. *Commissioner*, No. 76, October Term, 1952. The court below, however, held in effect that, because of tax-

payer's subsequently determined transferee liability for the unpaid 1942 and 1943 deficiency taxes of the company to the extent of the subsequently determined excessive part of his 1943 salary, his 1943 income tax liability should be recomputed by excluding from his gross income the excessive portion ($57,265.08) of the total salary ($87,265.08) he received and reported in 1943. The reason for the holding given in the brief affirming order of the court (R. 30) was—

> that the receipt of the excessive salary to the extent of which the respondent was held liable as transferee constituted "the bare receipt of property or money wholly belonging to another," *Commissioner* v. *Wilcox*, 327 U. S. 404, and that the respondent held the funds not for himself but for the creditors of the transferor * * *.

This conclusion cannot be reconciled with the controlling principles laid down in decisions of this Court.

A. The "claim of right" doctrine

The "claim of right" doctrine, "now deeply rooted in the federal tax system" (*United States* v. *Lewis*, 340 U. S. 590, 592), was stated in *North American Oil* v. *Burnet*, 286 U. S. 417, 424, as follows:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not en-

titled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * *

In *United States* v. *Lewis, supra,* this Court refused to depart from that "well-settled" "interpretation of the tax laws" (p. 592). In *Arrowsmith* v. *Commissioner,* decided November 10, 1952 (No. 51, October Term, 1952), where decision was based on the assumption that the "claim of right" doctrine applied despite subsequently determined transferee liability, the Court again referred to the "well-established principle that each taxable year is a separate unit for tax accounting purposes." (Slip opinion, p. 3.)

As the Court stated in *Lewis* (p. 592), the "claim of right" doctrine "has long been used to give 'finality" to the annual accounting period for which income taxes must be paid on income received. Payment of tax on the basis of an annual accounting period (see *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359, 363, 365-366; *Heiner* v. *Mellon,* 304 U. S. 271, 276-277) requires a determination of income at the close of each taxable year "without regard to the effect of subsequent events" (*Haberkorn* v. *United States,* 173 F. 2d 587, 589 (C. A. 6th); *Penn* v. *Robertson,* 115 F. 2d 167, 175 (C. A. 4th)). Under the "claim of right" doctrine, therefore, taxes are laid in the year of receipt upon funds received under a claim of right and without restriction as to their use, regardless of subsequent claims or

adjudications as to the recipient's right to retain the funds.

It is necessarily implicit in the "claim of right" doctrine that taxpayer-recipient's claim of right at the time of receipt may subsequently be defeated. Indeed this is clear in the opinion in the *North American Oil* case itself. There the Government had instituted suit to oust the taxpayer from possession of a section of oil land, a receiver was appointed to operate the property and hold the net income thereof, and in 1917, after entry by the district court of a final decree dismissing the Government's suit, the 1916 profits from the operation of the oil lands were paid to the taxpayer. Those profits were held taxable to the taxpayer in 1917, the year of receipt, even though the litigation on which the taxpayer's right to the profits depended continued in process and was not terminated until 1922. As the Court there stated (p. 424)—

> If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare *Lucas* v. *American Code Co.* [280 U. S. 445].

For a similar case, see *Commissioner* v. *Alamitos Land Co.*, 112 F. 2d 648 (C. A. 9th), certiorari denied, 311 U. S. 679. The more usual type of case is where the validity of the taxpayer's claim

to the funds at the time of receipt is questioned subsequent to the year of receipt, as in *United States* v. *Lewis,* 340 U. S. 590. There the "claim of right" doctrine was applied to that portion of the taxpayer's compensation which it was later determined had been erroneously computed and which, accordingly, ~~he was under~~ a legal obligation to return.[4] For similar situations—that is, where the doctrine was applied despite a later determination defeating the taxpayer's claim to the income at the time of receipt—see, e. g., *Haberkorn* v. *United States,* 173 F. 2d 587 (C. A. 6th) (involving a situation similar to the *Lewis* case); *St. Regis Paper Co.* v. *Higgins,* 157 F. 2d 884 (C. A. 2d), certiorari denied, 330 U. S. 843 (dividends received from wholly owned

[4] While cases of the type where the validity of the taxpayer's right to the funds at the time of receipt has been questioned are the most pertinent here, application of the "claim of right" doctrine is not of course limited to such cases. See, e. g., *Gilken Corp.* v. *Commissioner*, 176 F. 2d 141, 144–145 (C. A. 6th); *Capital Warehouse Co.* v. *Commissioner*, 171 F. 2d 395 (C. A. 8th); *Anderson* v. *Bowers*, 170 F. 2d 676 (C. A. 4th), certiorari denied, 337 U. S. 918; *De Guire* v. *Higgins*, 159 F. 2d 921 (C. A. 2d); *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C. A. 3d); *Jacobs* v. *Hoey*, 136 F. 2d 954 (C. A. 2d), certiorari denied, 320 U. S. 790; *Caldwell* v. *Commissioner*, 135 F. 2d 488 (C. A. 5th); *Detroit Consolidated Theatres* v. *Commissioner*, 133 F. 2d 200 (C. A. 6th); *Boston Consol. Gas Co.* v. *Commissioner*, 128 F. 2d 473 (C. A. 1st); *First Nat. Bank* v. *Commissioner*, 107 F. 2d 141 (C. A. 6th); *Commissioner* v. *Lyon*, 97 F. 2d 70, 73–74 (C. A. 9th).

subsidiary alleged to be void payments as in violation of trust indenture executed by declaring corporation); *Penn* v. *Robertson,* 115 F. 2d 167 (C. A. 4th) (money received under stock purchase plan allegedly void under state law); *Saunders* v. *Commissioner,* 101 F. 2d 407 (C. A. 10th) (officer's commission on sale of stock allegedly improperly received); *Griffin* v. *Smith,* 101 F. 2d 348 (C. A. 7th), certiorari denied, 308 U. S. 561 (bonuses allegedly received under unauthorized directors' resolution); *National City Bank of New York* v. *Helvering,* 98 F. 2d 93 (C. A. 2d) (illicit bonus).

In all these cases it was determined, in a year after the money was received, that there was in a legal restriction upon the taxpayer's disposition of the money, dating back to the time of receipt. Yet that was held immaterial—the crucial inquiry being, was it *received* under a claim of right without a *practical* restriction upon its disposition? Or, as it was put in *Rutkin* v. *United States,* 343 U. S. 130, 137, did taxpayer, as a practical matter, derive "readily realizable economic value from it" upon receipt? If the taxpayer holds under a claim of right in the year of receipt, he is taxable "regardless of any infirmity of his title" (*National City Bank of New York* v. *Helvering, supra,* p. 96) and even though he may be "'mistaken' as to the validity of his

claim" (*United States* v. *Lewis, supra*, p. 591).

In *Commissioner* v. *Wilcox*, 327 U. S. 404, relied upon by the court below (R. 30), it was held that embezzled funds were not income to the embezzler because the receipt of the embezzled funds constituted the "bare receipt of property or money wholly belonging to another" (p. 408). As the Court noted in *Lewis* (p. 591), however, the *Wilcox* case did not impair the "claim of right" doctrine. In *Wilcox* the Court found that the taxpayer-embezzler "received the money without any semblance of a bona fide claim of right" (p. 408) and in *Lewis* (pp. 591–592) the Court reiterated that in *Wilcox* it distinguished the *North American Oil* "claim of right" doctrine—

> on the ground that an embezzler asserts no "bona fide legal or equitable claim." 327 U. S. at 408.

In the present case, as we shall show, there was clearly far more than a "bare receipt of property or money wholly belonging to another" (*Wilcox*, p. 408). This taxpayer received his salary, as the stipulated facts (R. 20) disclose, believing it was his to do with as he liked and without any thought that he might someday be required to surrender part of it.

B. Application of the "claim of right" doctrine to these facts

In the present case taxpayer received in 1943 and reported in his income tax return for that year his total salary of $87,265.08. It was sub-

sequently held that the salary was excessive as compensation to the extent of $57,265.08 and that to that extent taxpayer is liable as transferee for the unpaid 1942 and 1943 deficiency taxes of the company, the 1943 payment to him having rendered the company insolvent. This transferee liability is the basis for the holding below that taxpayer's 1943 income tax liability may be recomputed by excluding $57,265.08 from his 1943 gross income.

The Commissioner's determination of transferee liability against taxpayer was made under the authority of Section 311(a) of the Internal Revenue Code (*supra*, pp. 3–4), which imposes no new liability but provides a summary procedure for enforcing transferee liability at law or in equity (*Phillips* v. *Commissioner*, 283 U. S. 589; *Phillips-Jones Corp.* v. *Parmley*, 302 U. S. 233; *Harrison* v. *Commissioner*, 173 F. 2d 736 (C. A. 5th); *Pearlman* v. *Commissioner*, 153 F. 2d 560 (C. A. 3d)—a procedure which is the same as that provided for collection of taxes directly from a taxpayer (see *Phillips* v. *Commissioner*, *supra*). The taxpayer's transferee liability in equity is based on the principle that a corporation should not be permitted to transfer its assets without consideration and leave remediless those having unsatisfied claims against the corporation. *Pierce* v. *United States*, 255 U. S. 398, 402–403. Thus, it has long been settled that a distribution of

assets of a corporation without consideration, made when the corporation is insolvent or which leaves the corporation insolvent, will, when those facts are established, be deemed to be impressed with a trust as of the time of receipt for payment of the corporation's debts. *Curran* v. *State of Arkansas,* 15 How. 304, 307–308; *Pierce* v. *United States, supra; Phillips* v. *Commissioner, supra,* p. 605; *Harrison* v. *Commissioner, supra; Scott* v. *Commissioner,* 117 F. 2d 36 (C. A. 8th); *McWilliams* v. *Excelsior Coal Co.,* 298 Fed. 884, 886 (C. A. 8th).

This "trust fund doctrine" (*Phillips-Jones Corp.* v. *Parmley, supra,* p. 235) is based on the theory of a constructive trust—a trust which arises where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it (Restatement of the Law, Restitution, Sec. 160, p. 640; 3 Scott on Trusts, Sec. 462, p. 2315). The constructive trust "is a remedial and not a substantive institution." Scott on Trusts, *supra,* p. 2316. As stated in 3 Bogert, Trusts and Trustees, Part 1, Sec. 471, it is "the device used by chancery" to compel one who unfairly holds a property interest to convey that interest to another to whom it justly belongs (pp. 3–4), "merely a tool of the court to work out an equitable result in the simplest fashion" (p. 5), "the formula

through which the conscience of equity finds expression" (p. 6). A court of equity constructs the trust, and makes the defendant a trustee "by virtue of the decree of the court" (Bogert, *supra*, p. 5), in order to vindicate the principle that the defendant has been under an equitable duty to give the complainant the benefit of the property ever since he began to hold unjustly (Bogert, *supra*, pp. 4–5).

In short, therefore, the liability of a constructive trustee arises only as the result of a determination or adjudication thereof, subsequent to the transactions or events upon which the liability is founded. It arises, not out of the desire or agreement of the parties, but rather out of the court's remedial powers.

While Section 311(a) of the Code (*supra*, pp. 3–4) dispenses with the requirement of an independent action in law or equity to impose and enforce transferee liability, no transferee liability exists or is enforceable under Section 311(a) in the absence of an assessment of transferee liability against an alleged transferee. *Hulburd* v. *Commissioner*, 296 U.S. 300, 305–306. Indeed, the Commissioner may assert transferee liability against any one transferee (*Phillips* v. *Commissioner*, *supra*, pp. 603–604) and no transferee is under an obligation to relinquish money or property received from a corporation until transferee liability is asserted against him or

until a fellow transferee seeks contribution from him.[5]

In the present case taxpayer's transferee liability resulted from an assessment against him based upon a determination of the Commissioner, affirmed by the Tax Court and the Court of Appeals, that $57,265.08 of his 1943 salary was in excess of reasonable compensation (and consequently a distribution of money of the corporation without consideration) and that the payment thereof rendered the payor-corporation insolvent. Cf. *Commissioner* v. *Renyx*, 66 F. 2d 260 (C. A. 2d); *West* v. *Commissioner*, 68 F. 2d 246 (C. A. 3d); *Lovejoy* v. *Commissioner*, decided June 15, 1942 (1942 P-H T. C. Memorandum Decisions, par. 42,344); *Estate of Murphy* v. *Commissioner*, decided August 26, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,205). As conditions precedent to the imposition of transferee liability for unpaid deficiency taxes of the corporation, it had to be determined, in the first instance by the Commissioner, (1) that taxpayer's 1943 salary was excessive, (2) that the payment of the excessive portion rendered the corporation insolvent, and (3) that the corporation was liable for additional taxes to the Government. None of these

[5] When once determined or established, transferee liability extends to the entire amount received by the transferee without consideration. *Phillips* v. *Commissioner*, *supra*, pp. 603–604.

determinations was made until after the close of the taxable year 1943. Transferee liability resulted only from application of the legal fiction of constructive trusts. The application of such a fiction presents an altogether different situation from receipt of money as trustee under an express or implied-in-fact trust, where the receipt is of money or property wholly belonging to another and precludes an assertion of claim or right thereto by the trustee as an individual. The constructive trustee is not even treated as a real trustee.

As stated in Scott on Trusts, *supra*, p. 2316:

> It is not infrequently said that where a person would be unjustly enriched if he were permitted to retain property, a court of equity "converts him into a trustee." The expression is misleading. The defendant is not converted into a real trustee. He is not even treated as though he were a real trustee, except that he is not permitted to retain the property for his own benefit. One would hardly say that where a quasi-contractual obligation is imposed the court converts the defendant into a contractor, or converts the obligation into a contract.

The "trust" relationship involved in the determination of transferee liability here, although retroactive in theory, did not arise until 1951 when the Commissioner's determinations were finally sustained. To be sure, this meant that taxpayers' claim of right in 1943, although it

existed in fact, was without basis in law. But this is of course immaterial. The possibility that a claim of right might subsequently be defeated is of the essence of the doctrine, the very function of which is to provide a practical and workable basis for the computation and payment of taxes an an annual basis, notwithstanding that possibility. What the court below apparently overlooked is that the test of receipt of funds "under a claim of right and without restriction as to its disposition" (*North American Oil* v. *Burnet, supra;* p. 424; *United States* v. *Lewis, supra,* p. 592) is necessarily a *practical* and not a legal test. Cf. *Rutkin* v. *United States,* 343 U. S. 130, 137.

It is certainly clear that, from a practical standpoint, taxpayer received the excessive portion of his 1943 compensation under a claim of right and without restriction as to its disposition. He received his entire 1943 salary as salary and reported it as earnings or income in the year of receipt. It is a stipulated fact that the entire salary was received "under a claim of right." (R. 20.). That it was received without any practical restrictions as to its disposition is confirmed by the stipulated fact (R, 20) that he "had no knowledge of the proposed disallowance of said salaries as a deduction to said company until September of 1944."

Taxpayer does not deny that his liability for unpaid taxes of the corporation was, as a practi-

cal matter, nonexistent and unsuspected when he reported and paid tax on his 1943 income. First apprised in September 1944 that a part of his compensation for 1943 might be held to have been excessive (R. 20), he strenuously contested his potential transferee liability in litigation extending into the year 1951. *Charles E. Smith & Sons Co.* v. *Commissioner,* decided May 12, 1947 (1947 P-H T. C. Memorandum Decisions, par. 47,128), affirmed, 184 F. 2d 1011 (C. A. 6th), certiorari denied, 340 U. S. 953. His liability as transferee arose only after the Commissioner's determinations had finally been sustained in that litigation.

In disagreement with the court below, other courts of appeals have applied the "claim of right" doctrine, notwithstanding that the money involved constituted a constructive trust fund retroactive to the time of receipt. Like the present case, *Fleischer* v. *Commissioner,* 158 F. 2d 42 (C. A. 8th), involved the applicability of the doctrine despite transferee liability resulting from the receipt of excessive compensation. The taxpayers there contended that the excessive amounts were received as constructive trustees and subject to an obligation to restore them to the corporation if its capital became impaired. The Eighth Circuit nevertheless sustained the Tax Court's holding in that case that the excessive amounts were taxable under the "claim of right" doctrine. In *St.*

Regis Paper Co. v. *Higgins,* 157 F. 2d 884 (C. A. 2d), certiorari denied, 330 U. S. 843, where a corporation received dividends from a wholly owned subsidiary which were alleged to be void payments as in violation of a trust indenture executed by the declaring corporation, it was stated (p. 885):

> But even though it now be conceded that the appellant could have been charged as a constructive trustee, the claim of right under which it did receive the dividends and hold them as its own until some time in 1938 is enough to make them income to the trustee for tax purposes in the year of their receipt.

In *National City Bank of New York* v. *Helvering,* 98 F. 2d 93 (C. A. 2d), which involved an illicit bonus consisting of bonds, it was contended, *inter alia,* that the decedent-taxpayer was not taxable on the bonds because he held them as constructive trustee. To that the Second Circuit replied in part (p. 95):

> They [the bonds] were of course the property of the Prairie company in the sense that it could have reclaimed them: * * *. But there are several cases in which persons have been taxed upon property which could be recovered from them.

In *Commissioner* v. *Alamitos Land Co.,* 112 F. 2d 648 (C. A. 9th), certiorari denied, 311 U. S. 679, it was contended that a fund collected by a judg-

ment creditor was a trust fund until disposition of the appeal. The Ninth Circuit held the taxpayer taxable on the fund, stating that it was on the reversal of the judgment that the trust relationship arose and that the reversal of the judgment was a newly created right.

In essentially the same circumstances as are involved in the present case, both the Second and Eighth Circuits have thus upheld application of the "claim of right" doctrine. *Commissioner* v. *Hartfield,* 194 F. 2d 662 (C. A. 2d), now pending before this Court *sub nom. Healy and Hartfield* v. *Commissioner,* No. 76, October Term, 1952; *Fleischer* v. *Commissioner,* 158 F. 2d 42 (C. A. 8th). Similarly, the Tax Court has applied the doctrine in holding that a stockholder's gain on the liquidation of a corporation may not be recomputed by deducting the amount of taxes which, as transferee, the stockholder paid in a subsequent year.[6] *Pittman* v. *Commissioner,* 14 T. C. 449; cf. *Furlong* v. *Commissioner,* 45 B. T. A. 362. Indeed, the applicability of the doctrine despite transferee liability for unpaid taxes has seemed so clear that it was accepted without question in cases in which stockholders who reported capital gains on corporate liquidations were in later years adjudged liable as transferees for claims against the corporations.

[6] That holding would require a similar holding in the present case and in the *Healy and Hartfield* case, *supra,* but in both cases the Tax Court failed to apply the "claim of right" doctrine.

Commissioner v. *Arrowsmith,* decided by this Court November 10, 1952 (No. 51, October Term, 1952); *Commissioner* v. *Switlik,* 184 F. 2d 299 (C. A. 3d). Both of those decisions assumed that the returns for the years in which the gains were reported could not be reopened to reflect the transferee liability and the only issue litigated was whether the payments satisfying this liability were to be deducted in the year of payment as capital or ordinary losses. In *Arrowsmith* this Court, in holding that losses were deductible as capital losses in the later years, looked to the transaction events in the earlier year in order properly to classify the nature of the loss for tax purposes, but expressly noted that—

> Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.[7]

The decision below is thus plainly at odds with the "claim of right" doctrine. The decision, being based on taxpayer's subsequently determined transferee liability under the constructive trust fund theory, would exclude from taxation any money or property received under circumstances in which a court of equity might thereafter impress a constructive trust. Since a court of equity will impress a constructive trust

[7] Slip opinion, p. 3.

upon any fund inequitably held by a taxpayer, the decision below would necessarily exclude from taxation *any* money or property as to which it was subsequently found the taxpayer had no valid claim as of the time of receipt, as in *Lewis* itself. Regardless of the reason why the receipt was illegal, whether because it was obtained by extortion, as in the *Rutkin* case, or because it rendered the corporation insolvent, as in this case, the characterization of the recipient as a "constructive trustee" would suffice to exclude tax liability. But, of course, if that were so, then *Lewis, Rutkin* and the other cases above cited were erroneously decided.

The instant case is, indeed, *a fortiori* from *Rutkin*, since the taxpayer there obviously knew at the time of receipt that he had no valid claim to the money. It may be noted that the court below has itself, in *Haberkorn* v. *United States*, 173 F. 2d 587, demonstrated why *Commissioner* v. *Wilcox*, 327 U. S. 404, upon which it here relies, does not preclude application of the "claim of right" doctrine in the present case. In the *Haberkorn* case the court below had before it a case similar to *Lewis;* that is, a case in which, after the taxpayer had received and reported compensation in 1942, it was found in 1944 that the compensation had been erroneously computed and that he was not entitled to a portion of it. The court there held that the entire amount received in 1942 was tax-

able in that year. *Wilcox* was correctly distinguished on the ground (173 F. 2d at 590) that, since in the *Haberkorn* case the overpayment was not discovered until a subsequent year—

> the debtor-creditor relationship, although definite and unconditional in 1944, was not recognized or even claimed in 1942. * * * The title to the money so received passed at that time from the employer to the employee. Subsequent developments in a later year gave rise to the obligation to repay it. * * * In the present case, at the end of 1942 Haberkorn had possession, title and unrestricted use of the money, and was claiming it and treating it as his own. There was not even any pending or ascertained claim against it. * * *

whereas in *Wilcox*—

> The receipt of the money by the embezzler and the obligation to return it occurred simultaneously.

The same is true here. As of the time of receipt this taxpayer, unlike the taxpayer in *Wilcox*, received the money involved under a bona fide claim of right.

The Tax Court suggested (R. 25), and taxpayer will undoubtedly argue, that "injustice" will result unless taxpayer is permitted to reopen his 1943 return so as to exclude the portion of compensation later found to be excessive and subject to transferee liability. In the *Lewis* case this

Court rejected a similar argument, stating (340 U. S. at 592 fn.):

> It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I. R. C. § 322 (b).

Taxpayer's relief for payment of the transferee liability is to claim a loss deduction in the year of payment. *North American Oil* v. *Burnet*, *supra*. Income is not to be taken out of the annual accounting system to produce a supposedly more equitable result to either the taxpayer or the Government.[8] *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 285–286. Incongruously, this taxpayer is seeking to reopen his 1943 return to enable him to take a deduction in that year for a payment which he admits he has not even yet made (see R. 20).

No injustice or inequity results simply because the Commissioner is claiming the excessive compensation on behalf of the United States for un-

[8] Taking the loss deduction in the year of payment, instead of reopening the earlier return, will in some instances work to the disadvantage of a taxpayer and in other instances to the taxpayer's advantage, depending upon the circumstances, particularly the rates of tax for the two years and the tax bracket in which the amount of the taxpayer's income places him.

paid deficiency taxes of the corporation while at the same time seeking to impose tax upon taxpayer's receipt of the money. In *North American Oil* the taxpayer was held taxable on income which the United States was claiming for itself even at the time of receipt by the taxpayer. It should make no difference to the instant taxpayer, or to the application of the "claim of right" doctrine, which of the corporation's creditors has claimed the excessive portion of his 1943 compensation.

CONCLUSION

The judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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NOVEMBER 1952.

APPENDIX

The following are the pertinent portions of the Tax Court's opinion in *Charles E. Smith & Sons Co.* v. *Commissioner,* decided May 12, 1947 (as amended October 28, 1947) (1947 P-H T. C. Memorandum Decisions, par. 47,128):

OPINION

The first question presented for our determination in these proceedings is—what is a reasonable allowance for compensation for services actually rendered by Smith to the corporation during the fiscal years ending July 31, 1942 and July 31, 1943?

The corporation in its income tax returns for the taxable years deducted $52,000 for the fiscal year ending July 31, 1942 and $87,265.08 for the fiscal year ending July 31, 1942, as compensation paid to Smith for services rendered by him during those years. The respondent determined that a reasonable allowance for compensation for Smith for the services he rendered was $25,000 for the taxable year 1942 and $30,-000 for the taxable year 1943.

This Court has repeatedly pointed out that the burden of proving the reasonableness of salaries paid by a corporation is upon the petitioner. In other words, the petitioner must show that the amounts allowed by the respondent were unreasonably small, since the respondent's determination is presumptively correct.

In the instant proceedings we have the rather familiar situation of a corporation

all of whose stock was owned by one individual, Smith, who was also its president and general manager. In the years preceding those here involved, the corporation paid him a salary which generally ranged from $4,800 to $7,500, but which amounted to $10,800 in 1937. Its business of manufacturing shirts and operating a small men's furnishings' store had not been very successful, and in 1940 it was forced into bankruptcy. As of July 31, 1941, its balance sheet showed assets of only $3,745.97, composed of cash, notes, accounts receivable, inventory, and furniture and fixtures, as against current liabilities of $9,850.02, and a deficit of $36,104.05. Shortly after the beginning of its next fiscal year, the corporation was the successful bidder on a contract for some tow targets for the Army Air Corps. On October 1, 1941, Smith, whose salary had been $4,800 in the preceding fiscal year, decided that it should be increased to $52,000 per annum, and at a stockholders' meeting on that date a resolution was adopted that his salary should be increased to this amount. Smith was the only stockholder present, and he knew at that time that the corporation was the low bidder on the Air Corps contract, bids for which had been opened on September 15th. When asked why he fixed his salary at $52,000, he testified that that was what he hoped his services would be worth; that the size of the Air Corps contract had something to do with it; and that he considered the amount of time "it seemed as though I would have to spend on the job." His salary of $87,265.08 for the fiscal year ending July 31, 1943, was likewise authorized by a resolution adopted by him as sole stockholder, and was computed on the basis

of 15 per cent of the corporation's net sales for the fiscal year.

Petitioners attempted to prove that $52,000 and $87,265.08 constituted a reasonable allowance for salary for Smith by describing in detail the services he rendered. Thus, it was shown that Smith prepared the bids that resulted in the contracts, arranged for the purchase of sewing machines and other necessary equipment for the purchase of a building sufficiently large to handle the work, hired the personnel, arranged for any financing necessary over and above the advance payments on the contracts made by the government, suggested changes in specifications and blueprints to facilitate mass production, assisted in the repair and servicing of machines, made and recommended new target designs, and spent long hours in the performance of these duties. No evidence was submitted by petitioners, however, indicating that any similar business paid comparable amounts to an officer or officers for services such as were performed by Smith, and cases cited in petitioners' brief as to salaries allowed by this Court as reasonable compensation are of little help inasmuch as the facts presented in those proceedings are not comparable to those here involved.

We are not impressed by petitioners' attempt to prove that Smith performed some unique and highly technical services. With certain minor exceptions, the targets were manufactured in accordance with specifications and blueprints furnished by the government, which also furnished most of the cloth used in their manufacture. The principal part of the manufacturing process consisted of cutting the cloth, sew-

ing it together on about forty sewing machines operated by girls, and attaching flotation tubes. The inspector in charge of procurement inspection for the Army Air Corps in the Cincinnati District during the taxable year testified, as a witness for the respondent, that the manufacture of the two targets was a comparatively simple process, and we have reached the same conclusion after a careful consideration of all the evidence. Our best judgment is that a reasonable allowance for compensation for services rendered by Smith was $25,000 for the fiscal year ending July 31, 1942, and $30,000 for the fiscal year ending July 31, 1943, and we have made such a finding.

* * * * *

The decision of the first two issues in favor of the respondent establishes the liability of the transferor corporation for the deficiencies and penalty determined by the respondent. There remains for consideration the liability of Smith, as transferee. The burden of proving this liability is on the respondent. Petitioners contend that he has not sustained this burden because he has not established that the corporation was made insolvent by the payment it made to Smith either during the taxable year ending July 31, 1942, or July 31, 1943. They also urge that credit or offset should be allowed, in determining transferee liability for whatever income taxes Smith may have paid by reason of having included in his individual income tax returns the full amounts paid to him during the taxable years.

Respondent contends that petitioner Charles E. Smith and Sons Company became insolvent during the fiscal year end-

ing July 31, 1942, and that therefore Hall C. Smith is liable as transferee for the deficiencies and penalty of the transferor corporation for that taxable year. While, as is hereinafter more fully set forth, we do find that Hall C. Smith has a transferee liability for said deficiencies and penalty for the taxable year ending July 31, 1942, we are unable to base such finding upon respondent's contention that Charles E. Smith and Sons Company was insolvent prior to July 31, 1942. Its balance sheet as of July 31, 1942, is in evidence and is set forth in our findings. It discloses that the book value of its assets as of that date exceeded the amount of its liabilities, exclusive of capital stock, by approximately $25,000. There is no evidence that the actual value of the assets at that time was less than the book value. The deficiencies and penalty determined by the respondent against the corporation for the fiscal year ending July 31, 1942, totalled $7,980.95. Even taking into consideration this potential liability for Federal taxes, the corporation was not insolvent at the close of the fiscal year. We cannot hold, therefore, that the distributions to Smith during that year rendered the corporation insolvent, and made him liable as transferee. [As amended by order dated 10–28–47.]

The events, however, which transpired during the fiscal year ending July 31, 1943, lead us to a different conclusion. As shown in the preceding paragraph, the corporation was solvent at the beginning of that year. The respondent on brief urges that the $30,000 distributed to petitioner on January 7, 1943, in redemption of 300 shares of stock should be considered as

one of the distributions which rendered the corporation insolvent and thus created transferee liability. However, no such allegation was made by him in his answer and this item, not being put in issued by the pleadings, cannot be considered by us. The allegation in the answer is limited to the distributions of $92,856.08, made to petitioner for salary and pension. On September 3, 1942, the board of directors adopted a resolution that Smith's salary for the fiscal year ending July 31, 1943, be 15 per cent of its net sales. This amounted to $87,265.08, $57,265.08, of which we have held to be in excess of reasonable compensation for Smith's services for that year. The amount of $5,591 contributed to the pension fund during the year for the benefit of Smith did not constitute a distribution of corporate profits to him. Cf. *Lincoln Electric Co.,* 6 T. C. 37, 51. Our question is whether as a result of the distribution to Smith of $57,265.08 the corporation became insolvent during the fiscal year ending July 31, 1943. If it did, Smith is liable as transferee. If it did not, he is not liable. [As amended by order dated 10–28–47.]

The balance sheet of the corporation as of July 31, 1943, shown in our findings, shows an excess of assets over liabilities in the amount of $65,084.32. The petitioners contend that, based upon adjusted valuations, the corporation was solvent at the end of the year and could pay any tax owing by it or even the proposed deficiencies determined by the respondent. They urge that the realty was carried at the book value of $75,008.54 against the mortgage obligation of $66,000, leaving an equity of approximately $9,000; that the realty was worth at

least the amount of $102,000 received for it at the sheriff's sale in 1945; that at this valuation the equity amounted to approximately $40,000 ($102,000 less $66,000); and that the net worth of the corporation at the end of the fiscal year would amount to $105,000 ($65,084.32 plus $40,000), or more than enough to take care of its tax liability for the fiscal year ending July 31, 1943.

Certain adjustments in the corporation's balance sheet as of July 31, 1943, are necessary in order to determine whether the distribution of $57,265.08 made to Smith resulted in the insolvency of the corporation. The item "Treasury Stock—$30,000.00", representing the 300 shares acquired from Smith on January 7, 1943, should be eliminated as an asset, and capital stock liability should be reduced from $60,000 to $30,000. The balance sheet does not reflect the actual value of the realty. It was purchased in April, 1942, at a cost of $85,463.85, and sold at a sheriff's sale in 1945 for $102,000. No evidence was submitted as to its actual value as of July 31, 1943. This was the respondent's burden and in order that petitioners may not be prejudiced by his failure to sustain it, we are making the adjustment to $102,000, as they suggest, although we realize that this figure represents the realty's value in 1945, rather than in 1943, and that its value in 1942 was $85,463.85. The balance sheet carries as the corporation's liability for income and excess profits tax, the amount of $22,427.70. This figure should be adjusted to $118,890.87, which represents the deficiencies and penalty in the aggregate amount of $7,980.95 for the fiscal year ending July 31, 1942, and the corporation's liability for income, declared value excess-

profits, and excess-profits taxes aggregating $10,909.92 for the fiscal year ending July 31, 1943. "In determining the question of insolvency, a liability for taxes, though unknown at the time, must be considered." *Scott* v. *Commissioner,* 117 F. 2d 36 [26 AFTR 245]. When these adjustments are made, the balance sheet discloses assets of $173,525.24, and liabilities of $207,912.63, exclusive of capital stock, and that the corporation was insolvent. This condition resulted from the aforementioned distribution of $57,265.06 made to Smith, and to the extent of this distribution he is liable as transferee for the deficiencies in tax and penalty, determined by the respondent for the fiscal years ending July 31, 1942 and July 31, 1943. *Scott* v. *Commissioner, supra.* [As amended by order dated 10-28-47.]

*   *   *   *   *   *